Performance Contracting in DoD

by

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[1] Views expressed belong solely to the author and are not the Department of Defense.

Introduction

In the fall of 1997, Secretary Cohen released the Defense Reform Initiative (DRI). The DRI proposed several managerial initiatives to reduce overhead and improve business operations within the Department. The Defense Management Council was created to implement DRI initiatives. One of those initiatives was to establish performance contracts between the DMC and most defense agencies or activities.[2]

Performance contracts are used by both public and private organizations. Economists often study the role contracts play in how public and private sector firms are organized. What functions are performed in-house or contracted out? Can firms grow so large that management and information inefficiencies overcome economies of scale? What are the optimal incentive systems for managers? How does a regulator ensure efficiency from regulated natural monopolies? How should contracts be structured to guarantee the desired outcome for both parties?

At the same time, a separate business-oriented literature has studied performance-based systems as a management tool. As a tool, performance contracts can be used between two separate organizations, between different components of the same organization, or between individuals (typically managers) in the same organization.

Both strands of the literature distinguish between public and private organizations, because public organizations have unique characteristics. This paper weaves those strands together to summarize the current state of knowledge about performance contracts and briefly discusses DoD experiences in establishing contracts with defense agencies.

Performance Contracts and Incentives

James Wilson (1989) and Avinash Dixit (1996) and William Bruns (1992) provide a useful overview of the main strands of the economic literature on public sector performance contracts. Viewed through an economic lens, government organizations rely on divers external and internal constituencies much more than commercial firms. The reliance on multiple principals means that an individual government manager has very diffuse power and often must implement vague or inconsistent goals. Government agencies should not be viewed as exclusively managerial or administrative organizations, because they must operate in a framework of politics.

Because of this political nature, economic and financial incentives in government agencies often are weak. Incentives may not be financial at all. Instead they may be complex quid pro quos in a larger, multidimensional bargaining game. Moreover, financial incentives (specifically monetary compensation) generally do not accrue to individuals in government, only

[2] Defense agencies and activities comprise those organizations that are not part of a military department.

to government organizations, and so the rewards of good performance may be tangible to top levels of management only and not to lower level staff in the field.[3]

This theoretical perspective implies certain types of institutional behavior. As Stephen Goldsmith points out (1997), traditional government accounting systems and financial reports are designed to prevent public servants from stealing money. Those accounting systems do not, however, encourage cost minimizing behavior. As Mayor of Indianapolis, no one could inform Goldsmith of how much it cost to fill a pothole, process a permit, or plow a mile of snow. Government finance and accounting practices therefore make benchmarking with other agencies or the private sector quite difficult.

They also can distort public managerial behavior, in that much more time is spent defending a budget than is spent identifying ways to operate efficiently. Government accounting systems are much better at measuring inputs, rather than outputs, and so managerial emphasis is placed there as well.

Even if government managers can identify inefficiencies, outside constituencies may not be able to do so. When they cannot, public sector management faces a problem of moral hazard. Moral hazard exists when the government manager holds information about the agency not possessed by regulators or customers. As a result, inefficient behavior on the agency's part

[3] Different DoD components have tried to reward individuals through employee "gain-sharing" programs. These programs often do not survive a GAO audit because of the difficulty in tying specific accomplishments to specific individuals.

is difficult to discover, and typical government finance and accounting systems are of little help in this regard.

Moral hazard and managerial inefficiency can exist in both public and private organizations. Performance-based systems are viewed as a way to align managerial incentives with the broader mission of the organization. In this respect, performance contracts are particularly important in the public sector because the typical budget-oriented information system provides so little data on performance.

Public Performance Contracts in Practice

Can performance contracts really overcome the weak incentives and political aspect of public organizations? Heckman, et al. argue that the case for public sector performance systems implicitly assumes that agencies have specified goals and that those goals can be quantified so that success or failure can be measured. They go on note that when the public sector performs a task where there are good private analogs both assumptions are satisfied. In this case, where outputs and performance are easily measured, market tests (or benchmarks) provide the ideal performance standard.

A more interesting case is when the two assumptions are not met but performance measures are implemented. One such case is provided by the earliest major federal performance system, which was created in 1983 by the Jobs Training Performance Act (JTPA).

JTPA fails the Heckman study's most basic criteria, because it requires that the government provide employment and training opportunities to those who can benefit from, and are most in need of, such opportunities. Those two goals – benefit and need – are conflicting. The people who most benefit from job training often are not the same individuals who most need job training. In addition, the benefits of job training are very difficult to measure.

JTPA uses two outcome measures of success: the number of people placed in jobs and their earnings levels. Incentive awards accrue only to the training center budget; therefore incentives for the individual workers are muted and may affect managers differently than their employees.

Like most government performance contracts, the JTPA performance standards ignore the cost of providing the service. The ideal measure of efficient job training would be social gains net of costs. In practice, the JTPA performance targets are described as measured levels at a particular point in time. Moreover, they are generally short-term targets (i.e., whether a participant had a job within three months), when in fact the true benefits of training may accrue over a longer term.

Incentives and the Consequences

Giving a more powerful incentive to one task draws effort away from other tasks. Implicitly or explicitly, every performance contract creates (or even distorts) incentives. One problem with government performance contracts is that rewards/costs usually accrue to top management or to entire offices. Economists would argue that this weakens the contract mightily, since it ignores the operators or staff who actually perform the work. The best commercial contracts will pay for performance.

Ideal performance-based systems will change managerial incentives to evoke changes in managerial behavior. Unfortunately, some of the resulting behavior may not be efficient. Courty and Marschke, as well as Heckman et al, in their studies of the job-training programs funded under the Job Training Partnership Act (JTPA), found evidence of “gaming” to produce desirable performance ratings. The JTPA rewarded centers based on the number of successful job placements at the end of the fiscal year. Both studies found that centers select people most likely to succeed in the particular targets measured a process they refer to as “cream-skimming.” This is possible because there is a moral-hazard problem in using labor-market based performance measures, because local-level bureaucrats can privately observe individual participants’ performance and manipulate the measure procedures to maximize their private rewards rather than social return. However, as Heckman et al, notes, cream skimming may promote social return in that the people most likely to benefit from the program receive it.

Even if managers are not actively gaming, performance measures can have unintended consequences. The JTPA incentive structure encourages people to report good outcomes and wait on bad ones, and to report bad outcomes only in good times. Because of the possibility for gaming and for unintended consequences, Courty and Marschke argue that in order for effective performance-incentive systems must continuously be adapted to address unforeseen problems.

All researchers studying the JTPA also identified a pervasive problem. Readily measured targets substitute for the ideal goals. Moreover, in most cases, the performance standards may not truly match organizational objectives.

Both the CBO and the GAO have reported incentive problems in performance contracting. Both have seen performance contracts become vehicles for defending budgets, and for protecting funding and personnel. Both also noted a tendency for agencies to report only positive results and the CBO recommended verifying the accuracy of data provided.

Current practices in Performance Contracting

Many federal agencies have implemented performance systems as part of the National Performance Review. Early results suggest these agencies are experiencing many of the same difficulties found in the JTPA. The Government Accounting Office (GAO), for example, surveyed 20 federal departments or agencies to examine the analytic and technical challenges in implementing performance-based initiatives (specially, implementing the Government Performance and Results Act (GPRA)). Many problems arose early in the process -- the bulk of the problems came in identifying goals and developing the actual measures. Common problems include:

- Moving beyond a summary of activities to identifying desired outcome or results.
- Separating activities that are under the agency's control from the impact of external factors
- Requiring data that are not currently available.

The GAO also reported that customers and other external constituencies needed to be included, because government managers face many more external constituencies than private sector managers. If those constituencies are not included in some form or another, the process can fail. However, survey respondents noted that internal and external stakeholders often had conflicted views of the intended results and reconciling those views could be impossible.

The GAO reported that many survey respondents reported problems sticking to output (and only output) measures. Apparently, it is easy to slip into measuring inputs, or attempting to regulate how a particular function is accomplished.

Respondents planned to solve these sorts of problems by creating an iterative process and planned to improve measures over time. For example, if data were unavailable for the initial contract, agencies can provide whatever data are available, noting its incomplete status, and agree to provide the data in future contracts.

Literature Summary

Economists are skeptical that performance contracts can change the political nature of government agencies, or that contracts can be structured in a way to promote socially efficient outcomes. To the extent they can succeed, the literature discussed above suggests that the best government performance contracts will do the following:

- include customers, external constituents and other stakeholders
- specify consistent goals
- specify outputs, rather than inputs or activity measures
- specify understandable, measurable, goals that are specific as to numbers and dates
- be revised regularly, to solve any gaming problems or unintended consequences, and also to improve data measurement
- include tangible rewards/penalties (whose life will change as a result?)
- integrate with budget formulation review and decision-making process
- start with relatively simple goals (“small wins”) and add more difficult goals in subsequent contracts

- Especially if the contract is part of the budget process, use the first contract to provide baseline data to ensure the goals are realistic estimates of what providers can achieve.

DoD Experiences

The first performance contracts were drafted in the spring of 1998 for four agencies: the Defense Logistics Agency, the Defense Finance and Accounting System, the Defense Contract Audit Agency, and the Defense Health Program. Most agencies were directed to submit draft contracts with their Program Objective Memoranda (POM).

Defense agencies generally provide goods and services to the military departments and other DoD components. DLA, for example, provides spare parts to the military departments through its distribution system. DFAS cuts paychecks, processes travel vouchers, and so on. The military departments pay for these functions either directly, through the working capital fund, or indirectly, with the agency receiving an appropriation. When the military departments pay directly, they are billed based on usage.

It was clear early on that some agencies had goals that were more easily measured than others did. One could estimate the cost of cutting a paycheck, for example, or the cost of an audit. But output is less easily measured for agencies involved in basic research, or agencies possessing a wartime mission exclusively. Even when goals are measurable, data are not always available or are not collected in a usable format.

Analysts drafting the performance contracts tried to incorporate the lessons learned from the wider literature. Customers and other stakeholders were part of the contract formulation process. The performance contracts were incorporated into the Planning, Programming and Budgeting System (PPBS) by requiring each agency to submit a draft contract with its Program Objective Memoranda (POM). This allowed contracts to incorporate costs, or prices charged to customers, which makes them somewhat unique among government performance contracts. Typical government contracts specify quality goals without regard to cost. Contracts used a common baseline – the programs submitted as part of the President's FY99 Budget. Many of the contracts incorporated benchmarking with commercial providers and customer surveys.

Nevertheless, it was difficult to limit the focus to outputs, and not inputs, in part because government managers (and therefore many data systems) traditionally focus on inputs. It was also difficult to identify tangible rewards or penalties. Overall, it is premature to assess whether these early performance contracts should be viewed as successes or failures.

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